RICHARD RUSSELL'S **DOW THEORY LETTERS, INC.**

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December 20, 1978 **LETTER 746**

Dec. 8, DJIA 811.85; PTI 882; A-D ratio –20.68
Dec. 15, DJIA 805.35; PTI 860; A-D ratio –21.77

MARKETS: **I had six honest serving men**
They taught me all I knew;
Their names were Where and What and When
And Why and How and Who." *Kipling*

Often, I'll sit and study my charts, and I'll ponder long and hard, because I know it's all there. The sum total of what everyone knows about anything that can affect the markets (and that includes politics, economics, business plans, rumors, dreams, successes, failures), it's all there distilled down into a few lines on the charts. Those lines are what we call the stock Averages. Add the bond averages, the commodity indices, the price of gold, and a few other technical measurements and you have it all. Ah, if only we were wise enough and experienced enough to *fully comprehend* the meaning of those little squiggles on the charts!

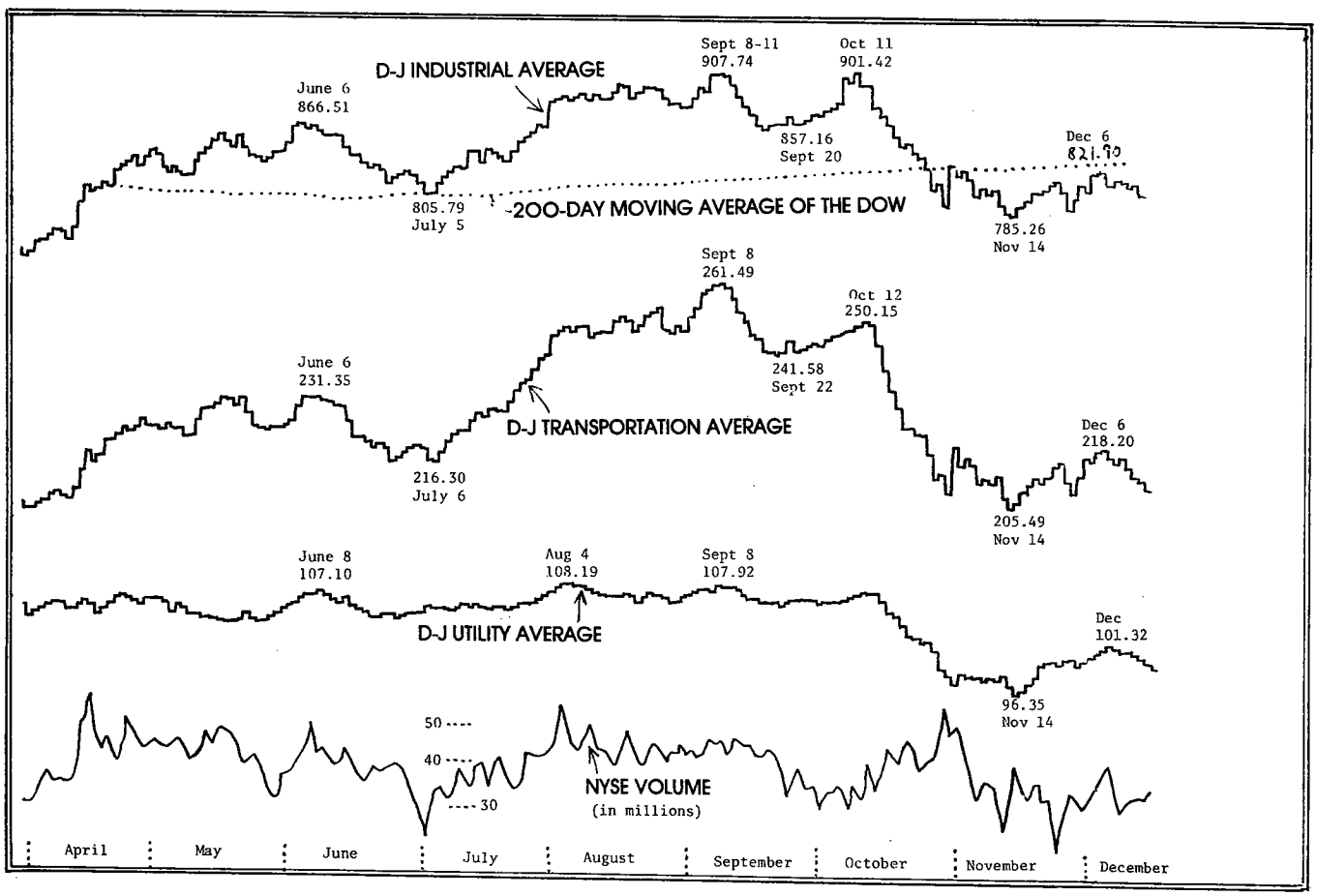
I obviously can't prove it, but looking over all my charts I get the uncomfortable feeling that December, 1978 represents the lull before the storm. The panic of October-November is over. During that panic the stock market was battered, the hard currencies (Swiss franc, the yen, the mark) declined violently, gold was smashed, many commodities were blitzed, and billions of dollars were lost by traders and investors.

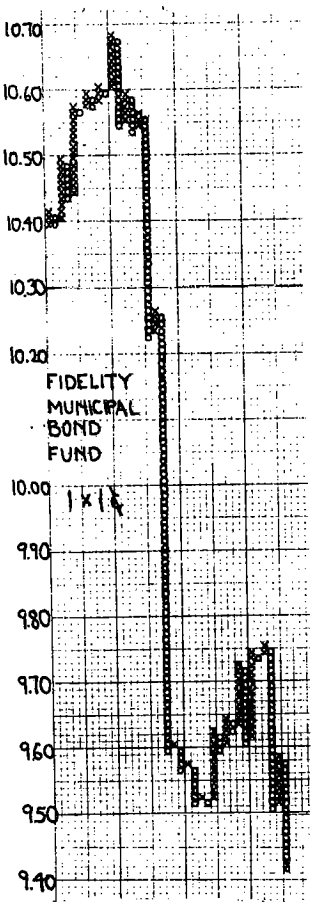
In the last Letter I described the typical aftermath of a panic– the initial shock, then the immobile period, then the automatic "recovery" that tends to recoup from 30% to 50% of the ground lost during the panic.

What I think we have been seeing in all the markets during late-November and December is the automatic post-panic recovery action. And so far, I must say that I don't find any of the recoveries particularly impressive.

But first, let's just deal with the stock market. From their November 14 lows (see chart below) of 785.25 (Industrials) and 205.49 (Transports), the two Averages formed little "head-and-shoulders' bottoms, and technically that was a bullish indication. But the "push" out of these little bottoms has been, to say the least, rather listless. Volume has been dull, breadth (the A-D ratio) has been insipid, and the whole rally has been brought on more from a dearth of selling pressure than any real concerted buying. In other words, prices "floated up" as selling pressure gradually receded.

On December 6 the rally reached a peak with Industrials at 821.90, Transports at 218.20. Note that these levels were BELOW the 830 (Industrials) and 220 (Transports) "breakout" levels that I mentioned in Letter 745 (pages 2 and 6). Thus, so





DOLLARS, LIQUIDITY: I'll stick to my prediction, made in the last few Letters, that the dollar is going to be KING for a while, and LIQUIDITY is going to be the name of the game for a while (perhaps during most or all of 1979). I believe that the big shocker coming up is going to be the very high level of interest rates (and evidently Henry Kaufman thinks so too). And that's what's going to make the dollar king.

The most liquid form of dollars is cash under your mattress (which is a bit impractical) or US Treasury bills (which is literally cash outside the banking system). And as I've said in Letter after Letter, I want the great bulk of my subscribers' assets in 91-day T-bills. I want it there because that is liquidity, real liquidity; it's cash available at a moment's notice. And from the looks of things, those who are liquid next year are going to be in a "contrary position." In short, they're going to have what nobody else has and what everybody WANTS.

When people need something badly, they pay dearly for it. That makes me think that cash in '79 is going to buy bargains. But if you're loaded with stocks and bonds and "things" (as almost everyone is today) you're not going to be able to buy bargains–you're going to be the one who is selling the bargains!

Many, many months ago I advised all my subscribers to sell their stocks and their bonds. I've held this position right along. Some subscribers argued with me, and no one argued harder than those who held the municipal bond funds, those "yummy" funds that allowed you to avoid federal taxes. I had two words for the muni funds–"Sell 'em." And if you ignored my advice and want to know what I think now, I'll say it again, "Sell 'em."

Back in October, 1977, when I first suggested selling our muni bonds, many of us were in the open-ended no-load muni bond funds. At that time Fidelity Municipal Bond Fund was selling in the 10.55 to 10.60 area. I use this fund as an example because it is the largest and because its price action is typical of any muni bond portfolio. Since its 1977 high of 10.69, Fidelity (see point & figure chart) has dropped a whopping 11.6%, equal to about two years' return on the fund. As you can see on the chart, this fund has given a fresh new sell signal as it recently plunged below 9.52.

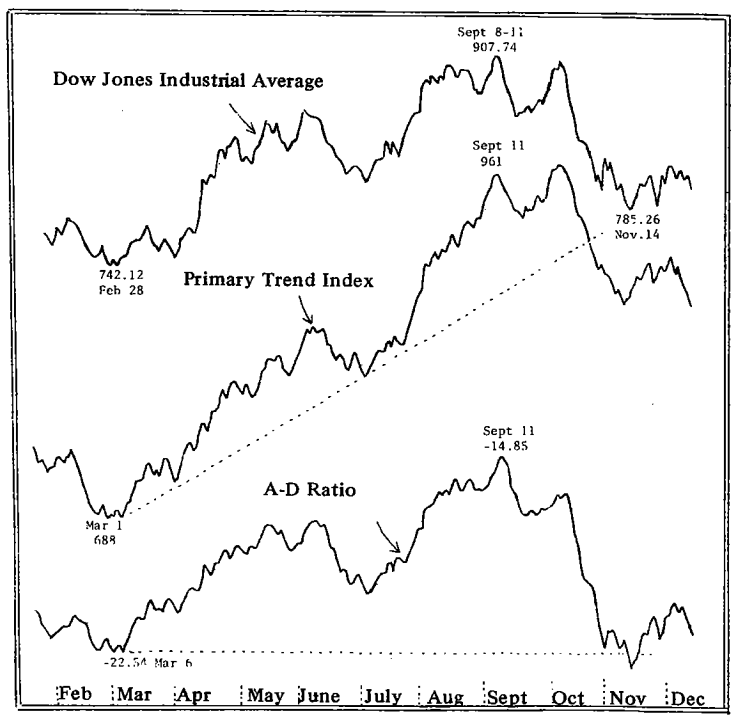
I believe this chart is providing a *preview* of what we are going to see as demand for money rockets up next year and as interest rates go (in many cases) to historic highs. These spiking interest rates will draw money from *everywhere* and *everything* and render the dollar king (for those who have dollars). In the wake of record interest rates, I expect to see stocks, bonds, commodities and most other tradeable items–substantially LOWER. I guess you could call that "Russell's year-end prediction for 1979."

(continued from page 1)

far strength has been lacking during December. It is also noteworthy that there hasn't been a single day since October 17 when daily new highs outnumbered new lows. Without the technical strength of daily new highs surpassing new lows, no rally can go very far!

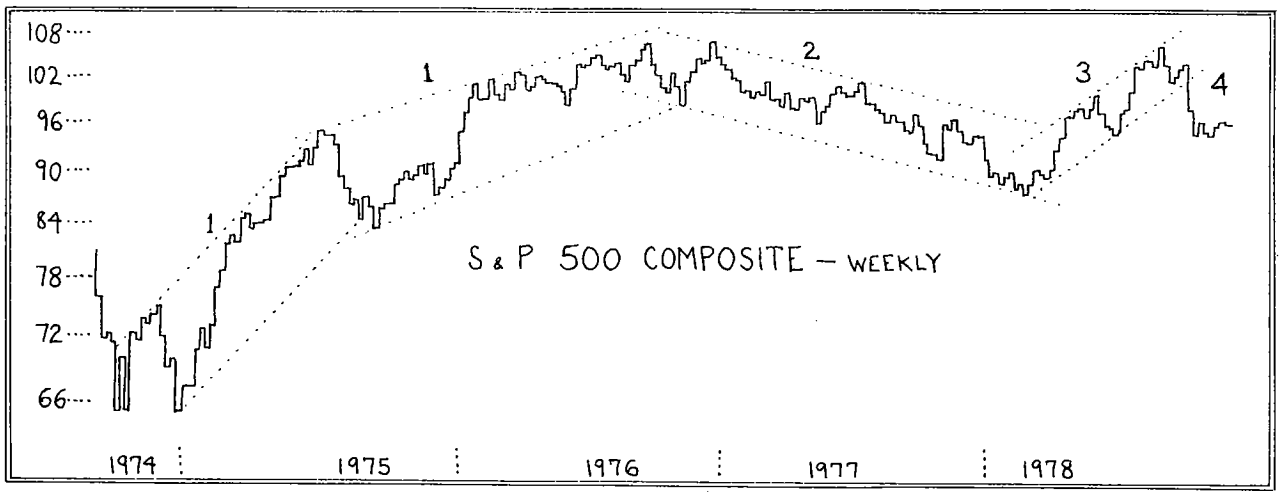
On December 13 the market received a subtle shock as the D-J 20 Bond Average broke sharply to its lowest level since 1976. Long-term Government bonds on the same day dropped to within a quarter point of their all-time lows. Thus bonds (and therefore rising interest rates) continue to provide fierce competition for stocks. Moreover, seasoned investors are aware that the bond averages almost always record bottoms before the stock averages.

Turning to the daily chart of the Dow, the Primary Trend Index (PTI) and the A-D ratio, we see the PTI tracing out a small downward zig-zag while the Dow tends to hold. The A-D ratio has drifted sideways following its initial rally off the November low. In all, the action has been unimpressive, but as long as the November lows hold on all indicators and averages (which they have done so far), we might still expect some version of a "yearend rally." I doubt, however, whether any upside action from here is going to be of the "fortune building" variety. Rather I'd concentrate more on potential messy action in the first quarter. As for call options, I'd close them out on any late-December upside move.



GETTING NOWHERE: Last week I retraced my weekly chart of the S&P 500 Composite (page 3), an excellent broad gauge of the overall trend (the S&P 500 is composed of the 500 largest NYSE stocks and is weighted for capitalization of each stock). The chart I show here is a ratio (semi-log) chart, so we are dealing with percentages of rally or decline.

One of the best ways to try to "make sense" out of any price movement is to channel those movements. In other words, prices tend to move at certain growth rates, and on a ratio chart these rates become quite clear. In channeling, we simply enclose these movements within rising or declining channels.



Since 1974, there have been four real changes in direction on the S&P 500. The first and the biggest move was the rise from the 1974 lows. This took the form of two rising rates, the original steep rise and the later shallower rise (marked No. 1 on the chart). This two-step rise carried from mid-1975 to mid-1976. From mid-1976 to early 1978 we had a major decline (No. 2 on chart) and this ended in February, 1978. From March through September, 1978 (No. 3) we had a steep rally, but this rally terminated in October, with a violent drop (No. 4) that wiped out a good part of the 1978 gains.

As this is written, we cannot know whether the current rally is simply part of the No. 4 drop or whether a new rising phase has set in. It is worth noting that this late-1978 advance is putting a potential "right shoulder" on the whole "toppy" looking formation that has developed during 1978. If that's true, then the current rally should die out in about the area of the first 1978 rally (just below No. 3 on the chart).

One thing is clear: each major swing since 1974 has been **shorter** than the preceding. For instance, the first (No. 1) rise was almost two years long. The No. 2 decline lasted over one year. The No. 3 rise lasted only 7 months. How long No. 4 will last is obviously unknowable at present. But if No. 4 is to be a major advance rather than simply a right shoulder to the 1978 top-type pattern, it will have to go above the 1978 high. Personally, I don't think this is going to happen. I just don't see it at this time.

One last observation regarding the S&P 500. If the investor had bought stocks in late 1974 or early 1975 and had sold out in mid-1976, he would have been ahead of the game. With all the "action" since mid-1976, note that the S&P 500 is now well below the mid-1976 highs. In fact, the S&P 500 is now only slightly above the peak recorded in the first half of 1975. Strange action if this is a bull market!

"LEAN CITY": A few years ago I wrote that the whole subject of timing was becoming **too popular**. Those of us who avoided the crushing bear market of 1973 and '74 attracted a good deal of attention. I know that because at the 1974 bottom subscriptions here reached a new high. And those of us who called the new bull market during late-1974 and early-1975 attracted even more attention, and I know that too because I received a good deal of publicity (along with a few others who identified the turn) and because all during 1975 subscriptions continued to arrive in record numbers.

And I guess it was around that time (or in early 1976) that I wrote that the art of timing had become much too popular. Everybody and his brother was either claiming to be a "timing expert" or was learning the "science" of timing. What happened after mid-1976 was almost predictable. Timing the market became almost more of a liability than a help. If you don't believe it, just study the chart of the Standard & Poor 500 shown above.

What's the lesson to be learned here? There are a number of them. First, I think the market becomes very difficult when everyone is trying to do the same thing. That "same thing" today is that everyone is trying to play genius by being a market timer. When everyone is trying to do the same thing on Wall Street, usually no one is very successful.

Second, a study of major advances in stock market history demonstrates the extreme importance of being "in there" early. As a rule, the largest percentage of any major multi-year rise occurs during the first year to year-and-a-half.

After that, it seems that more and more people become aware of the bull trend and the chances of profits diminish dramatically. The ironic fact is that if someone had purchased a broad selection of stocks in December, 1974 or January, 1975, sold those stocks out in mid-1976, and then switched to Treasury bills, he would have been ahead of the game.

Third, it is always hard to make money in stocks during an inflationary environment (when interest rates are high). Right now the T-bill rate is about 9% (higher if you go out six months to a year), and the inflation rate is near 10%. The yield on the Dow is currently 5.9% and the yield on the S&P 500 Index is about 5.5%. Thus, an investor holding a diversified portfolio of stocks is losing about 3½% in terms of loss of purchasing power due to inflation. If his stocks go down, he is obviously losing even more. Furthermore, in most countries in the world the short-term interest rates run about 2% or more above the inflation rate. Under that rule, the T-bill rate in the US should be nearer 11 to 12%, and thus there is a hidden pressure to push ALL money instruments above the inflation rate. With money instruments in the US presently "too cheap," the implication is that the current price of stocks (in terms of yields) is too high.

Fourth, in a brilliant new study, Steve Leuthold (special consultant to Piper, Jaffray & Hopwood) notes that over the past 106 years stocks produced an average compound annual growth of 2.4%. Dividends over those same years averaged 4.8%. Thus stocks from 1872 through the end of 1977 provided an annual

compound rate of return (growth plus dividends) of about 7.2%. But here in 1978, with the Treasury bills now yielding 9%, it is obvious that stocks are at an historical **disadvantage.**

Worse, Steve's studies show that stocks tend to do poorly during years of excessive inflation. His studies show that since 1872 there were 20 years of 4% to 6% inflation. During those 20 years the average compound rate of "growth" in stocks was **minus** 6.2%. Since 1872 there have been also 12 years of what Steve calls "extraordinary inflation" or inflation of 8% to 18%. The average compound rate of growth during those 12 years was **minus** 2.9%. Thus, in years of excessive inflation (over 7%) the investor hasn't even got the historical plus of the compound annual rate of 2.4% in stocks to help him. He has the historical disadvantage of a negative compound growth rate of minus 2.9% to minus 6.2%!

The year 1978 was a year of about 8% inflation, so that 1978 was not fated to be a good year for stocks under Leuthold's studies. The year 1979 shapes up as a year which will at least open up with high inflation (above 8%). Thus again, T-bills will tend to be safer and provide a greater return than the total return (growth plus dividends) on stocks, at least on an historical basis.

Fifth, it has been said that more money has been lost trying to beat inflation than has ever been made because of inflation. I firmly believe that. In other words, there is a pressure on individuals to "try to get even with inflation," and that pressure gives them the excuse for being in the market when they should not be. Thus, inflation becomes a loss-producer for many people. They "have to be invested in order to beat inflation," but what happens is that the markets beat them!

Sixth, and this is my own observation and it is very important: I have found that many (perhaps most) people would **rather lose money than be bored.** When I tell people to sit in 91-day T-bills and "just collect that 9% interest," that's a boring proposal. "Just sit there at 9%," they complain, "sit there when the market is doing this and doing that? But I'll miss a big move, I'll be out when the Dow doubles. And Charlie Gross across the street just made a killing in Bally!" Of course, the fact that a month later Charlie was "killed" in Bally makes no difference. The average player wants action, and T-bills (at any rate of interest) are a bore.

But the fact is that if I told an investor, "Look, Melvin, I've got a stock here that pays you 4% in dividends and I guarantee you that it will appreciate 5% a year," Melvin would be overjoyed. "A fat 9% total return," he'd shout, "where is it, what is it?" And I say, "well, it isn't exactly a stock, it's a T-bill paying you 9%." The reply would then be, "Oh, uh, a T-bill, hmmm, well I'm not going to get rich buying T-bills, am I!"

So I've found that the average man doesn't treat investments the way he treats his own business. In his own business, he's out to make profits, but in his investments the same man is looking for glory, a free ride, 100% profits, excitement, anything but a cold hard, calculating approach to making money.

Seventh, this is a most UNUSUAL period in that there is **no** real contrary opinion that one can embrace. Or put another way, it's very hard to find a position today where you are ALONE. I always feel most comfortable in the market when I am taking a position which seems logical to me but which is almost incomprehensible (or impossible) to the great majority. But today, some analysts are talking decline and depression, others are talking market advance and boom, still others are saying that we will just continue to witness sideways action in the market with more inflation.

I guess if I had to pick a logical position (logical in my own mind) that was most contrary, I would say that the market is going to hit the skids in 1979 and that the country is going into a deflationary period, a period which no one will be ready for (either in the markets, in their business, or in their own lives).

So here is my CONCLUSION: As I've promised so many times over the past year, I believe we're going to see a major, historic sell-off and very important stock market bottom coming up sometime during 1979 (probably during the first half). Buying stocks then will be as good an opportunity as it was in late-1974. But until that time, I suggest (as I have for months) that we all stay bored with our 91-day Treasury bills paying 9%. If you want to speculate, if you must speculate, then speculate with as little capital as possible and that means options (puts or calls).

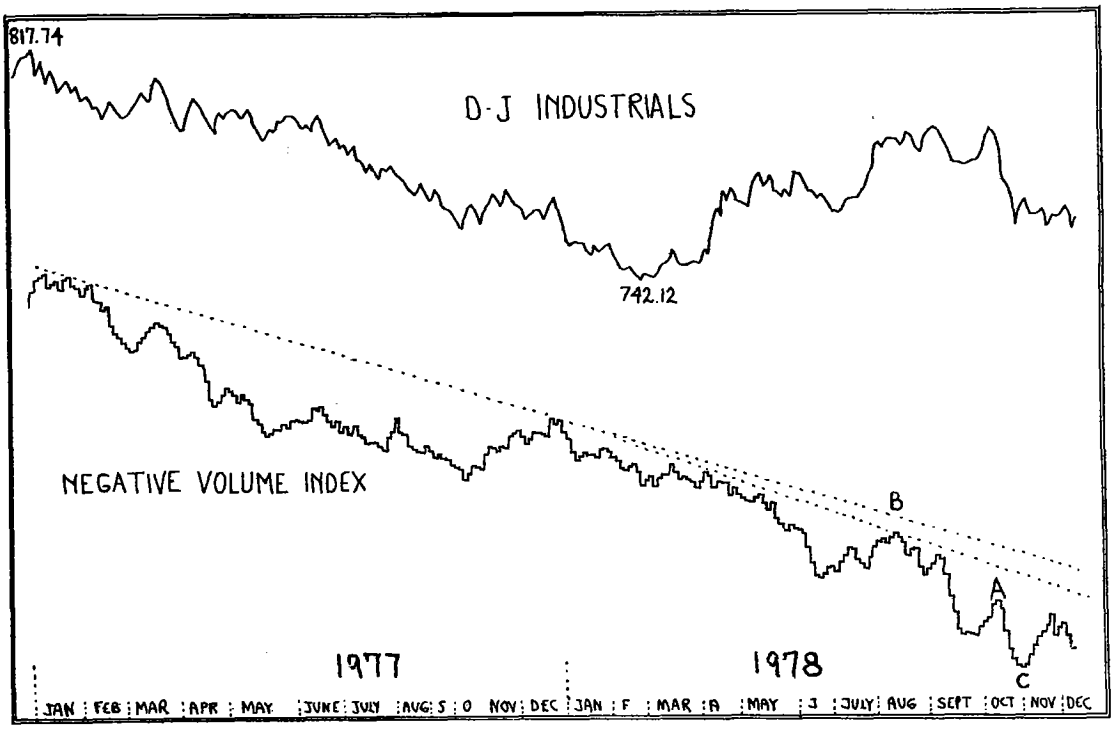
Patience is about the scarcest commodity in the markets. Those who can't exercise patience are almost doomed to learn patience and suffer losses. I am, by temperament, an impatient guy, but the market taught me to be patient, and it taught me the hard way. I think it took me about 10 years to get the message–and that message was, "Russell, you can't make a dime when **you** want to, but you stand a chance of doing very well when the market wants you to. So the lesson is–get in tune with the market, and become aware of your own impatience. When you do that, you stand a chance of coming out with more than you went in with." As I said, it's a lesson I learned the hard way, and it's a lesson I sincerely wish all my subscribers would learn (but not the hard way).

NEGATIVE VOLUME: Back in the 1930's and '40's Paul Dysart, founder of *Trendways* investment service, did a good deal of pioneering work on the advance-decline and volume. One of the concepts he came up with was positive and negative volume. Dysart separated the advance-decline statistics into two categories. A-D figures (daily) which occurred when total NYSE volume was higher than the preceding day was termed positive volume. A-D figures when NYSE volume was below the previous days was called negative volume. Thus, Dysart kept two indices (besides the regular A-D ratio), the positive volume A-D index and the negative volume A-D index.

Of the two special A-D indices, Dysart believed the negative volume index was by far the more important. He reasoned that "big money," the money that tends to set the trend and move the market prefers to buy when the markets are *calm*. The negative volume index is the "calm index," the one that is computed on declining volume days.

The public, the people who tend to be followers, reasoned Dysart, are driven to buy through excitement in the markets and high volume. The path of the public can be tracked by the positive volume index, the index composed of A-D statistics on days when volume is above the preceding day.

I have always been fascinated by Dysart's theories, and particularly by his negative volume index of advances and declines. This index, it should be remembered, only registers on days when volume is below the preceding day. Thus, we could conceivably get five negative volume entries in a single week if volume is down each day. Or a week may pass with no negative volume entry if a week arrives which includes rising volume each and every day.



I have kept up Dysart's negative volume index for about a decade (Dysart died many years ago). And I have found the index both useful and fascinating. One of the most interesting things about the index is that it tended to rise (on a long term basis) all during the 1940's and the 1950's up to about 1956. The index turned down in 1956, and except for intermittent rallies the negative volume index has been declining ever since.

I've often puzzled about this strange phenomenon, and the only conclusion I have come to is this: in 1958 the stock/bond yield relationship inverted in that the yield on stocks sank below the yield on bonds. This was obviously due to inflation, and the fact that bond yields from 1958 onward did not tend to keep up with the inflation rate whereas stocks (with their general appreciation characteristics (at least up to 1966) did provide a better total return than bonds. This inversion of stock/bond yields must have bothered investors, and I believe that factor shows itself in the decline of the negative volume index.

Let me put it another way: investors were **accumulating** stocks on balance all during the 1940's and the 1950's up to around 1956. After that, investment interests probably were distributing stocks (they were bothered by the abnormal stock/bond yield relationship), and this is why the negative volume index (which tracks the path of real investment money) tended to decline.

I have included my daily chart of the Dow and the negative volume index (NVI) going back two years. Note the steady downtrend in NVI. This downtrend continued even during the big 1978 rally, and it was one of the things that bothered me about that rally. Most important rallies in the past have been signalled by a definite upward zig-zag in NVI or a temporary reversal of a short-term declining trendline.

At present, I am most interested to see whether NVI can better its October peak at point A on the chart. If so, I would think we have a strong rally coming. If the lower declining trendline can be bettered on any rally, then so much the better. If the longer trendline can be bettered by NVI, I will be impressed. Finally, if NVI can muster enough strength to better the August peak at point B, it will be the strongest NVI action in a long, long time and I will turn outright bullish.

But so far, **no bullish signals** from NVI, and I am hoping the NVI doesn't break below point C to a new low. Someday, someday–NVI is going to amaze me by turning up (as it did during the 1940's and 1950's) and continue to climb. It is going to tell us that at last, the astute investment money is again accumulating. At that time, I expect the entire nature of the stock market to change, and I expect the breadth (A-D) to just keep climbing and climbing, as it did during the fantastic breadth explosion of 1942-46. We're obviously not there yet, but someday–someday . . .

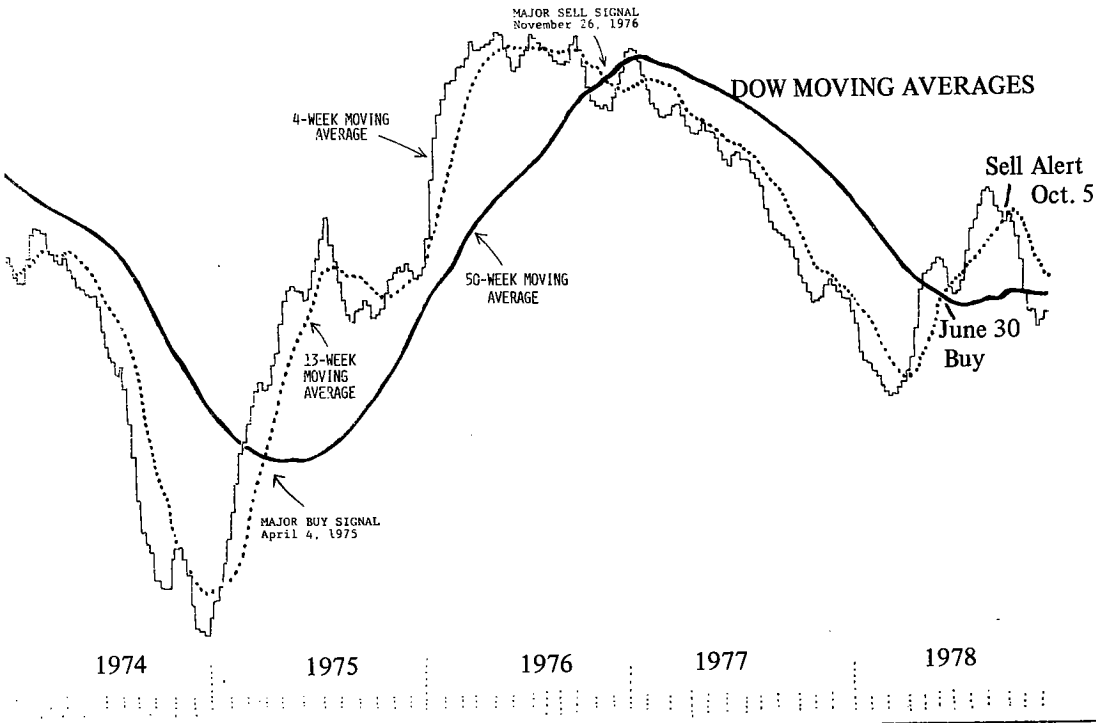
MOVING AVERAGES: This is the "fail safe" mechanical system which I use for operating in the market. In my experience, no system has ever been developed that will consistently beat the stock market. I've seen systems come, I've seen them go. I've seen new services inaugurated based on brave new systems and gimmicks. But sadly I must report that in the 20 years I've been in this business, few systems and services have survived. The market, monster that it is, seems to chew them all up alive. A new system emerges; it's inventor takes the system back (in retrospect) for ten to twenty years, and announces to the world that "if you had used this device, you would have run $1000 up to half a million!" But after the advertisements, after the interviews, after the buyers–comes the slaughter. And another gimmick bites the cruel and dispassionate dust of Wall Street.

The three moving averages (MA's) of the Dow constitute a system, a system so simple that I hesitate to even call them a system. But in the many years that I have run them, they have served me well. They don't always give good signals, they occasionally produce whipsaws, but they do serve one major purpose–they keep me thinking (and often sweating) when I ignore their signals.

As older subscribers know, major signals are given when the 13-week MA crosses above or below the 50-week MA. Buy and sell "alerts" are given when the 4-week MA crosses above the 13-week MA. By construction, a buy or sell alert must precede a major signal. Veteran readers also know that I accord most authority to a signal when it comes **in the same direction as the primary trend of the market.**

The last major buy signal occurred on the MA system on June 30, 1978 when the 13-week MA moved above the 50-week MA (the Dow was then 818). Since I was bearish on the primary trend, I down-played that signal (although in retrospect it was a good trading signal).

The sensitive 4-week MA recorded a peak of 892 on August 24, declined, then pushed to a double top (892 again) on September



7. The 4-week MA has been declining ever since. On the week ending October 5 the 4-week MA dropped below the 13-week MA, thus giving a sell alert signal. Two weeks later the market dropped drastically, producing its worst one week loss (in Dow points) in history.

It will still, under this sytem, require a penetration of the 13-week MA below the 50-week MA. The 13-week MA is now at 832, while the 50-week MA is at 821. Significantly, the 13-week MA turned flat two weeks ago and is now moving down. Any further Dow weakness will bring on a major sell signal in the weeks ahead.

NO PAIN: Most top athletes are familiar with the phrase, "No pain, no gain." What this means is that if you're not willing to train to the point where it HURTS, you're probably not going to be in top shape. I don't care whether you're a champion swimmer, boxer, runner, or football player, if you want to get there and stay there, brother, you're going to have to feel the pain.

Not so the US. Since World War II, politicians have dedicated themselves to giving the people everything they wanted—and more. On top of that, the politicians have deemed that Americans shall feel no pain. No recessions, no slowdowns, no unemployment, no education costs, no doctor bills, no hardship—so say our leaders. In fact, even today on the tail end of the second longest economic expansion since the 1940's, in the midst of rampant inflation and sky-rocketing debt in all segments of our economy, Mr. Carter, Mr. Miller and Mr. Blumenthal take turns hoping and promising that "there will be no recession in 1979." If it wasn't so pitiful, it would be comical.

It is only recently that a few of our braver and more intelligent leaders have dared to tell the truth. Former Treasury Secretary Simon told a good deal of the truth (if you overlook his gold stance) in his new book, "A Time For Truth." On December 3 the *New York Times* carried this article about Felix Rohatyn, the man who, more than anyone else, has held NYC together over the past few years. Rohatyn, a businessman, has had to deal with the "political bums" (as LaGuardia used to call them), and he knows what he's talking about. I thought this article important enough to include here.

My own feeling is that the US is now going the way of Britain. We are the "fat man" of the world, and if I were going to caricature the US I would draw us as "Consumer-man", a huge, overweight, creature sitting in a 5,000 lb. car, with a double-patty hamburger in one hand and a golf club in the other. The car would be filled with merchandise, TV sets, blenders, calculators, meat slicers, most of it made in Japan or Germany.

Does that description sound cruel? Well, it may sound cruel, but I feel it's fairly accurate. This nation is on

Rohatyn Says Problems of U.S. Threaten Its Future as a Nation

By LEE DEMBART

Felix G. Rohatyn, the retiring chairman of the Municipal Assistance Corporation, says that the economic, social and political problems facing the United States threaten the very structure of its democratic system and its future as a nation.

In a luncheon speech before the French-American Chamber of Commerce at the Pierre Hotel on Friday, Mr. Rohatyn, who is a senior partner in the investment-banking firm of Lazard Frères & Company, said:

"Our economy is out of control, our currency is in danger, our institutions of government is unresponsive or inept. . . .We are at war today. With inflation, with unemployment, with lack of education, with racial discrimination. We are, furthermore, not winning. If we lose, our system of government may not survive."

Since 1975, Mr. Rohatyn, as a private citizen, has played the leading role in arranging the financing that New York City needed to avoid bankruptcy. He has from time to time been mentioned as a possible United States Secretary of the Treasury.

But his experience with elected officials has not left him sanguine about them or their leadership skills. "A minority of the electorate gives power, with few exceptions, to men and women who follow rather than lead," Mr. Rohatyn said.

U.S.'s Problems Like City's

America's problems today, he said, parallel New York City's problems of 1975: increasing deficits papered over by accounting gimmicks, increasing reliance on borrowed money to finance those deficits, large hidden liabilities in the form of unfunded pensions and Social Security and the loss of private-sector jobs because of high taxes and low productivity.

Mr. Rohatyn said that what was needed was the equivalent of a wartime austerity program and coalition government, and he called on the President to "mobilize the country's dreams as well as its muscle and demand that the people and the Congress support" it.

"The hour is very late, almost as late for the U.S. as it was for New York in 1975," he said. "In the city, we fought against bankruptcy; in Washington they are fighting the same thing under different names. Controlling inflation, protecting the dollar, avoiding a recession."

"If the President loses this fight, if, collectively, we cannot create the climate to help him to win, the result will not be noteholders with a moratorium imposed on them or a wage freeze on the unions, but it could be the end of a form of government which, since the days of the French Revolution, has done more for more people than any other system ever invented. There will be no winners or losers then, simply the history of another nation that was unable to count its blessings and lost sight of its values."

The New York Times

Felix G. Rohatyn speaking at the Pierre Hotel on Friday.

a consuming binge that is so lavish, so expansive, so fantastic that it may take generations to recover from it.

Let me put it this way: if the US doesn't take an almost 180 degree turn away from its current policy of spending far above what it takes in, then I foresee the markets literally taking over and deciding the fate of the US in the years ahead. Remember, it took central banks around the world about 20 years to disgorge and liquidate their huge holdings of British pounds (following the fall of the pound as a reserve currency). The world is now in the process of backing away and protecting itself from what is left of the US dollar. The process of cutting down on dollars has already started. As things are now going, this will be a process which will last for at least a decade, probably two decades. The whole philosophy of spending and consumerism in the US will have to change if our power and leadership is to remain intact. So far, I see nothing to suggest that this is happening.

Over the last two years I've given more speeches than I have given in the previous ten years. I've done this because I think anything is better than just complaining and doing nothing. What's happening in this country is shaping up as a far bigger tragedy than sideways markets or slumping bonds. America is the last bastian of freedom. I'd hate to think that we traded that freedom for a split level house, wall-to-wall carpeting and an over-sized automobile.

NOTES & QUOTES: According to Ned Davis (J.C. Bradford) real takehome pay for workers has dropped 3.6% on a year-to-year basis. On top of that, the year-to-year rise in inflation is 8.9%. With another hike in the Social Security tax almost upon us, this puts heavy pressure on labor to "ask for more," and I mean more than Carter's 7%.

Meanwhile, the Fed keeps walking the narrow line. On the one hand, total deposits (including C/D's) are up a full 10% from a year ago, and the monetary base is up 10%. Thus, plenty of money is available. On the other hand, the discount rate is a record 9½% and six month T-bills cost the Government 9.3%. On the only truly free money market (because it is not under Fed control) 90-day Eurodollar rates are bringing 11½%. With demand for money still very strong, the pressure on interest rates is up. And the Fed continues to try to fight inflation with high interest rates while keeping everyone happy with an ever-expanding money supply. It's not going to work, and my guess is that interest rates are going higher (in 1979) than most people believe.

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OPEC has just announced a four-quarters in a row (5,3,3,3%) boost in the price of oil, a boost that amounts to 15% for the year 1979. The US was hoping for 5%, but at worst no more than 10% raise. The 15% boost has to be considered a shocker. I believe it represents an OPEC warning to the US.

The new rise in the price of oil is, on a surface level, inflationary. But make no mistake about it, the longer-term implications of this big increase is **deflationary**. The oil boost is bound to hurt the US balance-of-payments, and this in turn will put **further pressure on US interest rates**–at a time when interest rates are at or near historic highs. Furthermore, the OPEC boost will siphon off new funds from the US, Europe and Japan, and that action is basically deflationary. The 15% rise also shows us that Saudi Arabia (which wanted only a 5% boost) is giving in to the OPEC hard-liners. Finally, by putting the boosts on a quarterly basis, OPEC is telling the US, "Look, you'd better keep the dollar strong or you'll be hit with an oil increase every quarter from now on." All of which makes me surer than ever that the big story in 1979 is going to be told with INTEREST RATES. And rising interest rates will ultimately prove to be deflationary–they'll knock down every market in the nation and draw money from the moon.

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I'll be back in my home town of NYC speaking on January 16, along with Morgan Maxfield, Ronald Reagan, Bob Bleiberg, Tony Boeckh, with the whole evening MC'd by Louis Rukeyser. It will be at Avery Fisher Hall (Lincoln Center), which I hear is the best acoustical hall in the NE United States. This should be an outstandingly interesting evening, and for information you can call 1-800-821-5677. By the way, if any of my subscribers have the proper influence, I'd appreciate it if you could keep the City temperature above 32F on Jan. 15-17. After 17 years in Southern California I turn deep blue when the thermometer drops below freezing.

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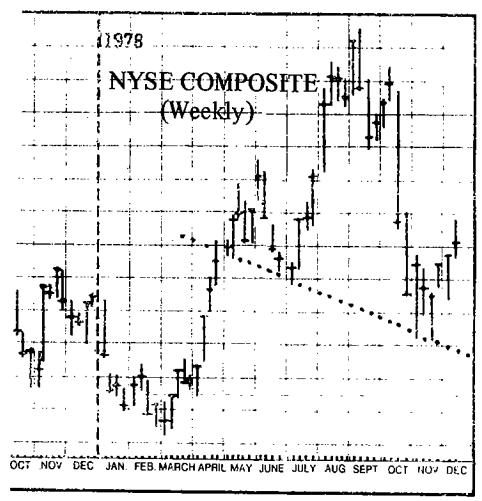
Maybe I'm obsessed, but everywhere I look I see right shoulders of head-and-shoulders tops. We're on the right shoulder in gold, in commodities and in the stock market, from the standpoint of my charts. For instance, here's a weekly chart of the NYSE Composite, and it's as well-defined and clear a head-and-shoulders top as I've ever seen. If all these H&S tops work out, then 1979 should look like the ski slope at Aspen.



In case you missed this, I wanted to include it here. Kaufman is a serious and brilliant student of the money markets, and no professional in his right mind will write off a Kaufman prediction.

By a WALL STREET JOURNAL *Staff Reporter*

NEW YORK–The nation's economy is heading toward a credit squeeze with record interest rates, according to economists for the securities firm of Salomon Brothers.

"We haven't seen the bite of credit restraint yet," stated Henry Kaufman, a partner of Salomon. He warned that when the bite does come some borrowers will be unable to raise funds and some will go bankrupt.

He expects those that can borrow will pay a stiff price. For example, he predicted that yields on top-rated utility bonds would hit a minimum of "10% to 11% sometime next year," up from just more than 9¼% currently. The banking industry's prime, or minimum, rate on business loans he said, could exceed 13%, compared with 11½% currently.

The glum forecast was made at a news luncheon at which the firm released its 1979 outlook for the flow of funds in the nation's economy.

GOLD: Everybody in or out of gold is supposed to be waiting to see how the first big US auction of 1.5 million ounces of gold is going to go. By the time you get this Letter, you'll know (but I, poor devil, have to write this before the fact). At any rate, my guess is that the auction will be a success and there will be bids for the whole 1.5 million ounces and more. But I also think that gold has already discounted the "good auction," and that there could be a downturn in gold AFTER the happy news of the auction.

I am including my 3 x 50-cent chart of gold (1st and 2nd London fix), a point & figure chart which shows every $1.50 rally or decline in gold (each box on the chart is 50-cents). What I see here is a giant head-and-shoulders top, a distribution pattern which tells me that gold should be substantially lower before 1978 is finished. The chart shows gold presently on the right shoulder of this H&S top. The upside resistance should be heavy in the 207-212 zone. Any decline in gold down to the 192 area would complete the top. I would think that if and when gold touches 192, we will see a panic break with gold heading into the 150-170 area.

"What could cause such a decline in gold;" I ask myself. And what set of circumstances has built such a huge top in gold? My guess is that gold's two mortal enemies lie just over the ridge (in the valley of 1979). The first is higher interest rates, and, of course, higher interest rates mean the cost (or sacrifice) in holding gold is increased. At present, with T-bills at around 9%, it is clearly costing a chrysophile 9% a year to hold gold.

The second mortal enemy of gold is declining inflation or deflation. Now it strikes me that every pundit, economist, soothsayer and pollster in the nation is talking higher inflation in 1979. "Can they all be right?" I muse. Well, sure they could all be right, but it is unusual when that many "experts," all saying the same thing, are all correct. As far as I know, the only leading market analyst in the country who is saying (out loud and in ads) that he sees deflation in 1979 is Tom Holt (the Holt Advisory). And I guess I'm the only one who is saying that I think Holt (and the current pattern of gold) could be right.

At any rate, the second chart is a daily chart of gold and my gold stock average (GSA). Note that GSA has started to back off, even while gold has acted a bit firmer. This could be a minor factor which will be straightened out by a little rally in GSA. The second thing that bothers me here is that I count a completed Elliott 1-2-3-4-5 pattern down. I then count an a-b-c correction which has taken the form of a weak "flat" with the "b" portion of the flat correction taking gold to a new low. If this is the correct Elliott count, then I would expect a new 5-leg wave down to start at any time now. Let's see how it all works out–but from a safe vantage point. I am still a proponent of an "on the sidelines" position regarding gold. The time for buying gold will come again–but I don't think we are there yet.

SEASON'S GREETINGS FROM THE RUSSELL FAMILY

NEXT MAILING: January 4